insofar as the connection between those rules and behavioral economics is concerned—I didn't connect the dots until I became a Commissioner at the beginning of 2006 both because I fell in love with the rival Chicago School of economics after *GTE Sylvania* in 1976[2] and because I was too busy with my antitrust defense practice in San Francisco to think big thoughts like that. Finally, I've discussed all these things with my two attorney advisers for antitrust, Mandy Reeves and Darren Tucker.

To focus the discussion today, I have structured my thoughts in three parts. First, I will briefly discuss some of the insights that behavioral economics has to offer. Second, I will survey some of the criticisms of behavioral economics. Third, I will offer some observations about where we go next. I should note that while I've done a good amount of thinking on this topic, I certainly don't have all of the answers – nor, do I think the behavioral economists. Nevertheless, I do believe that there is much we can draw on from their scholarship, even if it remains in a relative primitive state.

I.

At its core, behavioral economics posits that human beings sometimes act irrationally in making commercial decisions. Put differently, they do not always "profit maximize" because neither sellers nor buyers always strike the bargain that is the most advantageous to them. There are a number of reasons for this, according to behavioral economics.

First, there may be asymmetry in the information that is available to both buyers and sellers. For starters, some sellers may have information that other sellers lack. This is one reason why the FTC may consider deception by one buyer of other buyers—in the

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2 *Continental T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36 (1977).

context of standard-setting for example—to be an unfair method of competition. Similarly, some sellers may have information that buyers may not have. That is why the FTC has frequently considered a seller's failure to clearly and conspicuously disclose material information to buyers to be an unfair or deceptive act or practice. Personally, I always considered the FTC's Franchise and Vocational School rulemaking proposals in 1975 to be rooted in that information asymmetry—the vocational schools generally knew how many graduates they placed, but their students did not; franchisors generally knew how much their franchisees earned, but prospective franchisees did not.[3] To remedy this asymmetry, we required disclosure of that information. More generally speaking, behavioral economics seeks to identify similar instances of asymmetry which prevent perfect decision-making and then, if possible, adjust the default rules to eliminate as much of that asymmetry as possible.

Second, behavioral economics recognizes that instant gratification is more important than long-run profit maximization for many human beings. This means that, among other things, we demand much more to give up or sell an object than we would be willing to pay to acquire that object,[4] and we tend to overestimate our chance of success in the short term, but underestimate our chance of failure over the long term.[5]

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3 *See, e.g.*, "Proprietary Vocational and Home Study Schools," 16 C.F.R. § 438 (regulating unfair and deceptive advertising, sales, and enrollment practices, engaged in by some vocational and home study schools). For a discussion of the Rule which was ultimately struck down by the D.C. Circuit, see *Katharine Gibbs School Inc. v. FTC*, 612 F.2d 658 (D.C. Cir. 1979).

4 RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 63 (1992) (discussing the endowment effect).

5 *See, e.g.*, Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091-95 (2000) (discussing overconfidence and self-serving biases).

Recognizing these tendencies of individuals to focus on the present at the inevitable expense of the future, the FTC sponsored a workshop on mortgages in 2006 before the current financial crisis, in which we warned (too subtly I fear) that some of the more exotic mortgages, like some adjustable rate mortgages and balloon payment mortgages, might look great in the near term but might be very expensive long-term.[6] As some have suggested, particularly aggressive regulation in this regard – such as outlawing certain mortgage products – would perhaps be overreaching.[7] On the other hand, surely there is something we can do to reset the defaults or create incentives for consumers to purchase products that are less risky over the long run. Behavioral economics offers important insights in that regard.

Third, behavioral economics recognizes that human beings are creatures of habit—we tend to stick with what we have even if that doesn't make sense. This tendency is often referred to as the status quo bias.[8] This means that some people will make very conservative financial choices, such as keeping their deposits at one bank even when they are offered a better rate of interest by a bank which is essentially identical in all other respects. Likewise, the status quo bias can also play a role in the world of marketing, as companies have learned to their chagrin when they radically redesign

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[6] Public Workshop: Protecting Consumers in the New Mortgage Marketplace, 71 Fed. Reg. 15,417 (Mar. 29, 2006) (announcement of workshop); *see also* http://www.ftc.gov/bcp/workshops/mortgage/index.shtml (website accompanying workshop).

[7] Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL ST. J., July 23, 2009, at A15,
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conduct in the analysis of firm behavior.[11] As former Commissioner Leary aptly noted as early as 2003, however, this assumption does not account for basic agency problems.[12] Sellers, after all, no matter how large, are comprised of individuals who have "objectives of their own which do not necessarily coincide with those of the enterprise as a whole" and, as a result, the incentives of these "employee agents can prompt conduct that does not maximize the profits of their employer."[13]

These individual biases can manifest themselves in firm behavior in several ways that U.S. antitrust law does not predict. For example, although our Section 1 law assumes that implausible cartel agreements will collapse because participants will exploit opportunities to cheat provided those opportunities are in the firm's financial interests, some participants may not cheat out of perverse loyalty to other cartel members.[14] Likewise, although our predatory pricing law assumes that below cost pricing is not anticompetitive so long as the seller can recoup its losses, employees whose compensation depends on sales volumes may engage in below cost pricing even if there is no opportunity for the firm to recoup its losses.[15] And, although our merger law assumes that firms merge when it is in their self interest to do so, recent literature from the behavioral finance context suggests that CEOs and other individuals charged with

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[11] HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 134 (2005) (suggesting that the "entire antitrust enterprise is dedicated to the proposition that business firms behave rationally").

[12] Thomas B. Leary, *Thinking Creatively About Remedies: The Bipartisan Legacy*, 80 TUL. L. REV. 605 (2005).

[13] *Id. at 609.*

[14] *Id.*

[15] *Id.*

is that the neoclassical assumption of rationality is fundamentally at war with the position of behavioral economists that buyers and sellers do not always behave rationally. Unless behavioral economics can find a way to fit its insights within a neoclassical framework, behavioral economics will continue to be a likely target of the old and established neoclassical guard.

Second, many neoclassical economists (and their clients) yearn for certainty and predictability. There is a certain irony in this. When I started practicing antitrust law in 1965, there was plenty of predictability because certain practices were considered illegal hard for the results in these cases which subject these practices to a rule of reason entire professional existence is defined by one form of analysis (i.e., models that assume rational behavior), and a new form of analysis suggests your models are imperfect and that better evidence (i.e., the parties' documents and testimony) may be just as accurate at predicting competitive effects, there is likely to be some friction.

Fourth, there may be a less benign factor at work too. To date, neoclassical microeconomists have pretty much had industrial organization and antitrust economics to themselves. With the advent of behavioral economics (which draws on insights from other fields), they must share the antitrust turf with other professionals, including Ph.D.'s from other disciplines like sociology and psychology. In short, they are losing their monopoly on economic thought when it comes to antitrust.

Apart from these criticisms, critics have dispassionately attacked behavioral economics on two other grounds as well that, in my view, carry more weight. First, there is the critique that behavioral economics offers no single "organizing principle" like the self-correcting market principle that can be used as a default if there is no empirical evidence of the effects of a practice or transaction (or if the empirical evidence is inconclusive).[20] Having myself struggled to identify the best analytical framework to

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[20] *See, e.g.*, Michael Salinger, *Behavioral Economics, Consumer Protection, and Antitrust, in Competition Policy Int'l*, Spring 2010, at 66 (noting that "economic analysis necessarily relies on simplifying assumptions that sacrifice realism for tractability" and that the "rationality assumption plays so prominently in the literature because it is tractable . . . and yields some quite accurate predictions"); Douglas H. Ginsburg & Derek W. Moore, *The Future of Behavioral Economics in Antitrust Jurisprudence, in Competition Policy Int'l*, Spring 2010, at 97; Cass R. Sunstein, *Introduction, in* BEHAVIORAL LAW AND ECONOMICS 1, 9 (Cass R. Sunstein ed., 2000) (noting that "an enormous amount remains to be done" in the development of behavioral economics, including determining whether "behavioral economics [can] generate a unitary theory of behavior" or whether behavioral economics is "too ad hoc and unruly to generate predictions in the legal context").

account for different economic theories,[21] I have to concede that there is much to this critique.[22] That said, this can't be a reason to shut it out altogether: given the extent to which behavioral economics has questioned the assumption of rationality that underlies neoclassical analysis, rejecting behavioral economics whole cloth for lack of an organizing principle is arguably just another way of saying that an answer is better than no answer, however wrong that answer may be.

A second criticism is based on the view that behavioral economics is too subjective to provide government officials with a serious tool to reach the right ends. Under this view, government regulators – like the human beings discussed in the behavioral economics literature – are fallible too and, if they get intervention "wrong," that may actually magnify the consumer or societal loss.[23] If, for example, government regulators impose a default rule that is wrong, the wrong may have broad or perhaps universal application. My problem with this criticism is that it ignores the fact that, unlike human beings who make decisions in a vacuum, government regulators have the ability to study over time how individuals behave in certain settings (i.e., whether certain

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[21] *See, e.g.*, J. Thomas Rosch, "Antitrust Law Enforcement: What to do About the Current Economics Cacophony?" Bates White Antitrust Conference (June 1, 2009), *available at* http://www.ftc.gov/speeches/rosch/090601bateswhite.pdf.

[22] J. Thomas Rosch, "Managing Irrationality: Some Observations on Behavioral Economics and the Creation of the Consumer Financial Agency," Conference on the Regulation of Consumer Financial Products (Jan. 6, 2010), *available at* http://www.ftc.gov/speeches/rosch/100106financial-products.pdf (expressing concern about the absence of an organizing principle).

[23] *See, e.g.*, Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL ST. J., July 23, 2009, at A15, *available at* http://online.wsj.com/article/SB10001424052970203946904574302213213148166.html (99 116.16 T131n16.9lgov/so lv6 TD0 TcTl

default rules provide adequate disclosure to help them make the most informed decision). Thus, if and to the extent that government regulators are mindful of the human failings discussed above, and their rules are preceded by rigorous and objective tests, it is arguable that they are less likely to get things wrong than one would predict.

Of course, it may be the case that the concern with behavioral economics is less that regulators are imperfect and more than they are subject to political biases and that behavioral economics is simply liberalism masquerading as economic thinking.[24] My response to that is that political capture is everywhere in Washington and that to the extent behavioral economics supports "hands on" regulation it is no more political than neoclassical economics which generally supports "hands off" regulation. On a more serious note, perhaps the best way behavioral economics could counter this critique over the long run would be to identify ways in which the insights from behavioral economics suggest regulation that one would not expect from a "left-wing" legal theory.

III.

Where does this all leave us? I suspect that is what we will discuss next, but before we do, I'd like to leave you with three closing thoughts. *First*, as I have previously noted, I continue to believe that there may be a role for behavioral economics to play in merger review.[25] The Department of Justice and Federal Trade Commission's proposed changes to the U.S. Merger Guidelines reflect the agencies' joint interest in placing greater weight on what I call "direct" evidence of a merger's competitive effects

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24 Andrew Ferguson, *Nudge Nudge, Wink Wink: Behavioral economics—the governing theory of Obama's nanny state*, THE WEEKLY STANDARD (April 19, 2009), *available at* http://www.weeklystandard.com/articles/nudge-nudge-wink-wink.

25 Rosch, "Managing Irrationality: Some Observations on Behavioral Economics and the Creation of the Consumer Financial Agency," *supra* note 22.

Consumer Policy oriented towards our consumer protection mission.[28] That workshop resulted in a report discussing possible applications of behavioral economics to consumer protection law. The Commission can and should hold a similar conference in the next few years that would explicitly discuss applications of behavioral economics – and perhaps other new economic thinking – to competition law as well. Such a conference, like similar conferences that have begun to occur,[29] could stimulate further research and discussion not only by economists, but by competition law experts and practitioners about whether and to what extent behavioral economics should play a role in competition law going forward.

Third and more concretely, I would suggest that if there is a role for behavioral economics to play in conduct cases more generally, the challenge for decision-makers (be they judges, advocates, or regulators), is to identify the right doctrinal framework that balances the need for predictability against the risk of under-enforcement that comes with an overly rigid approach. I think the D.C. Circuit might very well have been on to

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[28] FTC Bureau of Economics, Conference on Behavioral Economics and Consumer Policy (April 20, 2007), slides and papers accompanying conference *available at* http://www.ftc.gov/be/consumerbehavior/index.shtml.

[29] At its 2008 annual meeting, the American Antitrust Institute's (AAI) keynote speaker and panelists discussed the applicability of behavioral economics to competition policy. AAI, Audio Recordings from AAI's Annual National Conference, *available at* http://www.antitrustinstitute.org/Archives/2008conferenceaudio.ashx (last visited June 4, 2010). Likewise, at the ABA's *Next Generation of Antitrust Scholarship Conference* held at NYU law school in January 2010, several papers applied behavioral economics to antitrust policy. *See* Max Huffman, *Behavioral Exploitation and Antitrust*; Avishalom Tor & William J. Rinner, *Behavioral Antitrust: A New Approach to the Rule of Reason after Leegin*, University of Haifa Faculty of Law Legal Studies Research Paper Series (Dec. 1, 2009), *available at* http://ssrn.com/abstract=1522948; Maurice E. Stucke, *Am I a Price-Fixer? A Behavioral Economics Analysis of Cartels, in* CRIMINALISING CARTELS: A CRITICAL INTERDISCIPLINARY STUDY OF AN INTERNATIONAL REGULATORY MOVEMENT (Caron Beaton-Wells & Ariel Ezrachi eds. Hart Publishing Oxford forthcoming 2010), *available at* http://ssrn.com/abstract=1535720.

something in the *Microsoft* decision when it applied less of a bright-line approach and more of a balancing test.[30] Such an analysis (which is essentially premised on the rule of reason framework) could perhaps allow advocates the flexibility to make their case using all of the economic tools available to them in any particular circumstance. To be sure, behavioral economics would need to be sufficiently credible to be admissible as evidence,[31] but I don't think we're all that far from crossing that threshold.

I look forward to discussing these and other ideas with the rest of the panel.

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